STATE OF CALIFORNIA — DEPARTMENT OF FINANCE

MAJOR REGULATIONS STANDARDIZED REGULATORY IMPACT ASSESSMENT SUMMARY

DF-131 (NEW 11/13)

STANDARDIZED REGULATORY IMPACT ASSESSMENT SUMMARY

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1. Statement of the need for the proposed major regulation.

During the past 15 years, from 2003 to the present, four insurance companies have gone insolvent largely because of their involvement with high deductible workers' compensation insurance policies. Nationally, these four companies had an estimated $624 million in combined incurred losses that were passed to the guaranty associations of the various states. Of the combined incurred losses, approximately $360 million occurred in California and were passed to the California Insurance Guaranty Association. Then through special assessments the remaining solvent insurers have to cover for the failings of other workers' compensation insurers who had insured employers with insufficient collateral. These insurer insolvencies can make it harder to pay for and secure medically necessary treatments for injured employees. The proposed regulation levels the competitive marketplace by stipulating that insurers require employers to properly collateralize their deductible obligations. The benefit of avoiding such future insolvencies lessens the risk of a situation where the remaining solvent insurers have to pay for the underwriting shortcomings of insurers who have not properly mitigated risks and might then face new assessments. This regulation will protect insurers, employers, and employees.

2. The categories of individuals and business enterprises who will be impacted by the proposed major regulation and the amount of the economic impact on each such category.

The regulation is expected to impact all industries (excluding federal, state and local governments as they are nearly all self-insured). Specifically, it is expected to impact employers with more than 100 employees that utilize workers' compensation insurance policies with deductibles of $100,000 or more. Because insurers currently do not separate collateral by state or insurance line, the Department assumes that the total impact of the regulation will include impacts to California business enterprises that also operate in other states. The Department believes that given the size and complexity of the California economy, it is not reasonable to assume that the potential for adverse economic impact on California business enterprises is limited to only physical locations in the state. The Department prepared detailed economic impact estimates by industry at the upper-, middle-, and lower-range scenarios with variation in two key assumptions. These scenarios include the costs of securing collateral of 1, 2 and 3 percent as well as a range of current collateralization at 60, 70 and 80 percent, respectively (see SRIA Appendices A, B and C). Additionally, the Department prepared Appendix B-2, a subset of Appendix B that calculates California specific job and business impacts at the midrange cost and collateral assumptions.

3. Description of all costs and all benefits due to the proposed regulatory change (calculated on an annual basis from estimated date of filing with the Secretary of State through 12 months after the estimated date the proposed major regulation will be fully implemented as estimated by the agency).

The costs are estimated to be equal to the cost of fully collateralizing the deductible amount of an employers' workers' compensation policy (plus any additional deductible on a multi-line policy). The cost of securing collateral was estimated to be between 1 and 3 percent. The amount of collateral needed was estimated at three different ranges, based on the industry average and the Department's assumptions about the impacted insurers. At the mid-range estimate, which the department believes to be the most likely outcome, the aggregate direct costs to employers, including employers with multi-state policies is $21.4 million, and the estimated impact on total economic output is $46.4 million. At the same cost and collateral assumptions for physical locations in California, the estimated direct cost is $6 million, and total loss to output is $13 million.

The benefits are due to the anticipated managing of the risk of insurer insolvencies. As a result the guaranty fund would not need to assume claims responsibility for these insurers and would not have to assess the remaining solvent insurers and ultimately policyholders. The benefits are the same across the three different cost scenarios, as the variability with the estimates on the cost side is not anticipated to affect the benefits. The Department estimated that the total direct benefit, including employers with multi-state policies is $41.6 million (including a $1.7 million benefit to insurers, because assets will not need to be liquidated to pay claims), with the total benefit to output exceeding $90 million.

Specific to employers' within California, the estimated direct benefit is $24 million (including a $1 million benefit to insurers, because assets will not need to be liquidated to pay claims). The estimated beneficial impact on total economic output is $52.1 million.

4. Description of the 12-month period in which the agency estimates the economic impact of the proposed major regulation will exceed $50 million.

The Department provided cost and benefit estimates on an average annual basis for a 12-month period beginning after the regulations are fully implemented. If an insolvency relating to involvement in high deductible policies is prevented in a given year the benefits would far outweigh the costs, greatly exceeding the $50-million threshold. However, history suggests that insurer insolvencies related to involvement in high deductible policies do not occur annually, happening on average about once every four years. Despite the relative infrequency of insolvencies, the estimated total annual average benefit to economic output exceeds $90 million per year, with $52.1 million accruing to businesses located within the state of California.

While the costs are predicted to be mostly stable, there are some variations anticipated due to the cost of obtaining collateral and the amount of collateralization currently required by each insurer. At the upper-range cost scenario estimate (SRIA Appendix C) the projected loss to output of $92.9 million, including multi-state policies, exceeds the $50 million threshold. This uppermost estimate assumes a 3 percent cost of securing collateral and the worst of the three possible shortfalls in the amounts employers have already collateralized, i.e. 60 percent.

5. Description of the agency's baseline:

The Department reviewed the credit rating and capital surplus of all high deductible workers' compensation insurers to determine the total number of insurers and the aggregate amount of deductible credit that would need to be collateralized. From there, the Department used the percentage of high deductible premiums as a proxy to estimate which California businesses with more than 100 employees might have the financial resources needed to utilize high deductible policies. The Department analyzed employment size data for all industries (excluding local, state and federal government). Then the market share of the impacted insurers was applied to those businesses that might utilize high deductible policies to estimate how many employers might incur additional costs relating to securing collateral.

After determining which businesses might be impacted, the Department had to account for California business enterprises that conduct business nationally and have physical locations in other states that would be covered under the same workers' compensation account. Finally, the total impacts were evenly distributed across industries based on the estimated number of impacted business.

6. For each alternative that the agency considered (including those provided by the public or another governmental agency), please describe:
   a. All costs and all benefits of the alternative
   b. The reason for rejecting alternative

Alternative 1: *Alternative 1: Apply these regulations to all workers' compensation policies with deductible amounts of all sizes.*
This alternative would place additional costs on employers and insurers by requiring collateral for all deductible policies no matter how small. This alternative adds additional costs and provides the same benefit. This alternative at a minimum would have a direct cost of $22 million, slightly more than the regulation. The total impacts on economic output of this alternative include a projected loss of nearly $48 million and benefit of $90 million. Small deductible policies do not present the same insolvency risk and by requiring collateralization for these policies no additional insolvencies are expected to be prevented. Most importantly, this alternative conflicts with the best practices of the industry.

Alternative 2: *Require that the collateral requirements provide protection only for California specific collateral.*
The direct cost of this alternative would be less than the proposed regulations, estimated to be about $4.8 million, assuming a collateral cost of 2 percent and current collateralization of 70 percent (SRIA Appendix D). However, it is also anticipated that the benefits of this alternative would be much more limited than the regulation. Large employers often have accounts with multi-state or multi-line policies, with deductible obligations that span more than just the state specific workers' compensation part of the policy. This alternative does not provide the option for insurers to require collateral for other lines. Due to the smaller levels of collateralization and the restrictions on when collateral could be used, the Department estimates that this alternative would likely only be half as effective as the regulation at managing the risk of future insolvencies. After accounting for the limited effectiveness of this alternative and the exclusion of the multi-state option, only an estimated direct benefit of $12 million would be attained by this alternative. The total impacts on economic output of this alternative include a loss of $10.4 million and benefit of $26.1 million.

7. A description of the methods by which the agency sought public input. (Please include documentation of that public outreach).

The Department sought public input through a pre-notice public discussion held on March 16, 2018. Members of the public and stakeholders attended the discussion in two of the Department's locations, the San Francisco or Sacramento offices, where the interested parties were able to discuss the proposed regulation via video conference. The robust discussion included topics such as the size of impacted employers, insurers preferred types of collateral, the cost of obtaining the different types of collateral and industries that potentially would be impacted. In its invitation to the pre-notice public discussion, the Department listed two alternatives that were discussed and ultimately incorporated into the proposed regulations, and asked for additional alternatives. For more detail on what was discussed please see the attached pre-notice public discussion invitation.

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8. A description of the economic impact method and approach (including the underlying assumptions the agency used and the rationale and basis for those assumptions).

The Department consulted industry experts, the 2016 Workers' Compensation Large Deductible Study published by the NAIC, and various statistical data including employment, receipts, and size of business. The Department's actuarial office provided empirical data and was able to analyze workers' compensation payout patterns to determine the aggregated direct cost and benefit impacts. Then size of business data was used to estimate the number of business that would be affected and the average impact on each business. The Department utilized RIMS II multipliers, published by the Bureau of Economic Analysis, to calculate the indirect and induced economic impacts and the industry specific job gains/losses.

Agency Signature	Date April 20, 2018
Agency Head (Printed) Geoffrey Margolis, Deputy Commissioner & Special Counsel to the Commissioner	